1. Introduction and overview

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Historically, the American economy operated in two spheres. One, the competitive sphere, gave enterprises substantial discretion to set their prices and other terms of trade as well as the products they would market. Antitrust law oversaw this sphere with a set of rules that prohibited some kinds of conduct and existing structures (e.g., price fixing among competitors and single firm monopoly) and intervened to block only those major mergers that might create an undue risk of anticompetitive conduct or create a monopoly. In the view of many antitrust scholars, courts and business people, merger law was a central force in retaining an open and competitive market structure that both enhanced the long-run dynamics of these industries and permitted a light-handed control over specific conduct.

The other sphere of the economy was the subject of direct economic regulation. This was most overt in the traditional fields of public utility service (gas, electricity and telecommunications) and transportation (rail, road and air). However, it also included health care and many elements of financial businesses (insurance, savings associations, banks and credit unions).

Within these spheres, regulation has varied with respect to the degree of direct control over the ultimate conduct of the businesses. Traditionally, in the areas of public utilities and transportation, all aspects of service and any combination among firms was subject to direct review and control by state and/or federal regulatory authorities. The same was true in financial sectors, with some greater discretion with respect to the pricing of many services, such as loans. While merger law has played a role in controlling the structure in some sectors for many decades (e.g. banking and natural gas), it has not been a pervasive influence and most often the regulatory agency has had the ultimate say on the validity of any combination.

Starting in the 1970s with airline and rail deregulation, and recently highlighted in the Telecommunications Act of 1996, economic policy in the United States has shifted strongly in favor of competitive markets as the means to encourage and discipline business enterprises in the formerly

regulated sectors. The basic vision of this policy was the belief that allowing firms to make their own price and output decisions would bring about preferable results with respect to price, innovation and service to the ultimate benefit of competition and consumers. Traditional regulation was condemned as inefficient, ineffective and protective of established interests.

The problematic character of this somewhat simplistic vision of economic organization became evident with the collapse of Enron (which operated in gas and electricity markets), which contributed to the disruption of electric markets in the western United States, the bankruptcy of WorldCom (telecommunications), which affected the organization of those markets, and mergers between railroads, which generated a host of complaints about the quality and price of deregulated service on freight railroads, especially following the consolidation of the Union Pacific and Southern Pacific. In addition, the unregulated market model has failed to control the upward spiral of health care costs. In all of these fields, there has been a great deal of continuing debate and discussion concerning the appropriate policy. Indeed, after deregulation failed to bring about the promised benefits and, in some cases, caused serious and widespread economic harms, the public policy pendulum may be swinging back toward more regulation. In the interim, however, massive merger movements have taken place in formerly regulated industries.

The transformation of formerly regulated or noncompetitive industries to competition is closely linked with merger movements. The historical record demonstrates that once faced with competition, leading firms in these industries began to merge. This has been the pattern in airlines, banks, railroads, electric and gas utilities, health care and, with great prominence, telecommunications. These merger waves seem, on their face, to conflict with the model of a perfectly competitive market system with many participants. However, it must also be remembered that the prior patterns of ownership in all of these industries were determined through a regulatory process and not a market one. Hence, substantial changes in the ownership and organization of these markets are a predictable consequence of the change in economic context in which the firms operated. Indeed, before deregulation, industries from health care to railroads to electric power possessed excess (and probably inefficient) capacity only because of the lack of competitive pressure. After 2000, with the collapse of the 'dot com' bubble (excessive optimism about internet communications) and the exposure of false income statements at WorldCom, there was pressure to merge economically strapped telecommunications firms. The airline industry, for different economic reasons, is undergoing similar pressure to consolidate. The same issues now face electricity and many banking services.

Along with these structural changes, some of these industries, e.g., telecommunications and health care, have experienced dramatic technological innovation, often unleashed by deregulation. This has brought about substantial changes in the kinds of services and products provided to the market as well as in the structure of the enterprises themselves. Indeed, the potential for innovation in these industries can dramatically alter the implications of combinations among firms that in the past held dominant positions. For example, the development of wireless telecommunications increasingly provides a substitute for wire systems and so may greatly limit the market power of the dominant (previously regulated) local phone companies.

Against this backdrop, antitrust and regulatory authorities, who are now charged with facilitating competition, must evaluate mergers. What are the relevant markets? How should competitive impact be measured? How can and should decision makers incorporate expected future market contexts into their review? These questions are remarkably consistent over the entire range of previously regulated industries despite many industry-specific considerations.

This book includes a series of chapters that examine competition and merger policy experience in the key industries subject to the deregulatory process. In each chapter, a highly qualified expert in the field has reviewed the evolution of the industry, its transformation toward greater reliance on market institutions, and the resulting transformation of structure and conduct. These chapters reveal clear similarities in the economic, legal and public policy issues that have arisen following deregulation of these economic sectors. This set of industry studies provides a good basis to discern the consistency of the problems and the relative success of differing responses to these issues over a range of industries going through similar transformation. This book also provides guidance for decision makers to evaluate concerns for economic viability of individual firms in relation to the longer-term goal of enhancing the potential for workably competitive markets.

The American economy is not the only one undergoing a process of movement toward greater reliance on market mechanisms. Throughout the world, many formerly state-managed and state-owned economies are privatizing enterprises and, at the same time, moving toward market competition as the primary vehicle for allocating goods and services. The EU provides a particularly relevant point of comparison with the American effort. As a mature economy organized in a quasi-federal system, the EU has its own history and unique economic issues. It has a robust competition policy, perhaps even stronger today than the American model, and it faces the challenges of both integrating national economies into a regional

economic unit (a challenge America overcame 200 years ago) and, at the same time, moving historically regulated industries toward a market model.

By developing a better understanding of the issues and analytical problems resulting from past large-scale deregulation in the United States, these case studies also provide important insights for future market deregulatory actions and contribute to better understanding of the merits of re-regulation in some contexts. Finally, these studies will offer a relevant counterpoint to efforts to understand the complex situation facing countries in Eastern Europe and Asia that are seeking, with mixed success, to move from state-managed to market-oriented economies. To assist in that comparison, this book also includes a chapter that contrasts the American experience with that of the EU with respect to some of the industries where the EU has also sought to move toward a more market-oriented regulatory scheme.

The next three chapters provide case studies on the traditional public utility industries of electricity (Chapter 2), natural gas (Chapter 3), and telecommunications (Chapter 4). Gas and electricity are subject to regulatory oversight by the same agency, the Federal Energy Regulatory Commission (FERC), yet the experience of merger review and subsequent market performance has been substantially different. The contrast rests on the inherent characteristics of the services involved in providing electricity and natural gas as well as the historical structure of the industries and the differences in the specifics of the overall legal regime governing the two types of energy providers. The experience with telecommunications provides a case study in regulatory lag in the face of a dramatic transformation of technology. The old telephone monopoly of AT&T held back the use of cost-saving, new technology such as microwave transmission, digital dialing and wireless communications. The creation of competition has gone hand in hand with both the commercialization of already existing technology and an increased pace of innovation. The consequence, as shown in Chapter 4, is that regulatory oversight was always behind and legislation often failed to address the most important aspects of the emerging technology at all. For example, the 1996 Telecommunications Act did not impose any regulation of the Internet, save for an attempted control over pornography.

The next two chapters examine key transportation industries, railroads (Chapter 5) and airlines (Chapter 6), that were freed from command and control regulation in the 1970s and 1980s. Both chapters conclude that deregulation has had positive effects. However, each chapter points to the failure on the part of those designing the new policies to foresee and appreciate the changed dynamics of the resulting markets. Consequently, the increased concentration in these markets resulting from mergers may

have undermined the potential gains that deregulation might have made possible.

Chapter 7 turns to an examination of the transformation of health care with a focus on the merger of hospitals. While various new forms of organizations have come to be the primary method of providing health care services in the last 30 years, it is striking that there is no national agency charged with overseeing this transition in the health care field and formulating rules to facilitate market conduct. This chapter provides important lessons for public policy. The absence of any agency having overall responsibility for the development of market processes creates problems at least as bad as the problems of agency failure highlighted in the prior chapters. Despite some rhetorical commitment to the market, there was not the kind of legislative or regulatory action necessary to achieve viable market processes when interested parties, especially hospitals, made claims for special status.

Chapter 8 examines the banking industry. This industry was once subject to fairly detailed regulation of rates and other financial services. Different types of depository institutions such as commercial banks, savings banks, savings and loan associations, and credit unions, had distinct market niches. Regulators attempted to shield each type from undue competition from other types of depository institutions as well as to limit intra-industry competition. Starting in the 1960s, this model gradually disintegrated as banks and the other types of depository institutions expanded the range of their services resulting in more direct competition among the types of institutions. In addition, legislative and administrative actions expanded the permissible geographic scope of their activities thereby increasing the number of actual or potential competitors. This competition was an important factor in inducing much more innovation in financial services for both individuals and businesses. Nevertheless, banking remains a regulated industry because of the need to provide deposit insurance to protect consumers and to check the consequent risks of strategic conduct by banks. As the barriers to banking competition have come down and the ability of banks to expand (in both geographic area and product lines) has grown dramatically, a vast restructuring of the industry has taken place. The question, once again, is whether that restructuring is consistent with the public interest in obtaining the best advantages from the market process.

The final substantive chapter (Chapter 9) provides a comparison of the European Union's efforts to deregulate comparable industries with the American experience. The primary focus is on gas, electricity, banking and airlines. While the EU has also engaged in substantial supervision of telecommunications, the area was omitted from this survey because of the

great complexity resulting from a simultaneous transformation in structure and in ownership (from public to corporate with respect to many of the systems). Europe generally uses public ownership for its railroads, with the exception of the United Kingdom, and therefore a comparison of the railroad industries is not possible. Similarly, European approaches to health care have largely precluded the use of market mechanisms to date. It is possible that in the future the EU may decide to move both railroads and health care toward more market-oriented ways of doing business, but that is not yet the case.

The EU legal system for dealing with competition policy, and mergers in particular, is different from the American system. The EU law provides much more exclusivity than does American law for specific decision makers dealing with specific types of transactions or conduct. Basically, the Commission itself has nearly exclusive jurisdiction over transactions or conduct that have substantial effect across the EU while national competition authorities have similarly exclusive authority with respect to more localized events. The EU has also been much more self-conscious about its overall decision to embrace competition as a fundamental policy to govern the various industry sectors. At the same time, the actual outcomes of the EU process of merger review and of industry deregulation have been similar overall to the American experience. For this reason, it is relevant to note that in one industry, airlines, it appears that the EU may have achieved better outcomes than the United States despite taking a somewhat more regulatory approach to the industry.

Chapter 10 concludes the book by identifying some of the common themes and implications of the specific case studies. This overview highlights the network nature of each industry and suggests that, overall, the case studies show a need for regulation that will both constitute and facilitate competitive markets. Too often, as the case studies show, the effort to move regulated industries toward a greater market orientation was frustrated because the regulators lacked the tools, the expertise or the commitment to govern the transition to competition. In addition, decision makers sometimes lacked an understanding of how unregulated markets would operate and failed to foresee problems. Their ignorance, however, is understandable given the often dramatic changes in the way these industries will operate once rigid and frequently inefficient regulatory commands were lifted. In an interesting and instructive contrast with the American model, the stated policy of the EU expressly recognizes the need for a comprehensive transition plan when industries are moved toward a market model. However, here too it is worth comparing the ambition of the EU policy with its actual accomplishment. Ultimately, the process of change is a continuing one. Success is highly dependent on thoughtful analysis and a

responsible regulatory and legislative environment. Unfortunately, the political process, as the American experience demonstrates, has only rarely and never consistently provided this institutional framework.

Given the obstacles that effective reform and sound merger policy face, perhaps the most remarkable feature of the following case studies is that they all conclude that the economy is better off, or at least not worse off, as a result of the reforms.